EDITOR'S NOTE

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86-856

No. (1)

IN THE SUPREME COURT

OF THE

UNITED STATES

OCTOBER TERM, 1986

VIRGINIA L. DARMSTADTER,

Petitioner,

vs.

THE SOUTH CAROLINA NATIONAL BANK,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

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QUESTIONS PRESENTED.

1. Did the decision below incorrectly deny de novo review when:

(i) without notice to the opposing party, the district judge had the prevailing party prepare and submit an ex parte proposed order;

(ii) the district judge's final order was substantially identical to the proposed order, especially in the crucial factual findings; and

(iii) all of the evidence in the district court was documentary?

2. Are promissory notes issued contemporaneously by a class of investors to an unseen prearranged lender as part of a common investment venture, and which are payable out of the pooled earnings of the venture (if successful), "securities" within the meaning of the federal securities laws?

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No.

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vs.

The South Carolina National Bank,

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PETITION FOR A WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

Petitioner, Virginia L. Darmstadter, ("Darmstadter") requests that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fourth Circuit entered in this action on September 4, 1986, which affirmed the judgment of the United States District Court for the District of South Carolina.

OPINIONS BELOW.

The opinion of the court of appeals, which is unreported [1], is reprinted in the appendix hereto at 1a. The order of the district court is reported at 622 F. Supp. 226 (D.C.S.C. 1985) and reprinted at 13a.

JURISDICTION.

The judgment of the Court of Appeals for the Fourth Circuit was entered on September 4, 1986. No petition for rehearing was filed. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTES INVOLVED.

This case involves the construction and purpose of Sec. 2(1) of the Securities Act of 1933, codified at 15 U.S.C. § 77b(1) and Sec. 2(10) of the Securities Exchange Act of 1934, 15 U.S.C. § 78c(a)(10). It further involves

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[1] The mere fact the opinion below is unpublished does not reflect on the merits of a petition for certiorari. See, e.g., County of Los Angeles v. Kling, 106 S. Ct. 300, 301 (1985) (Stevens, J., dissenting).

the construction of Sec. 35-1-20(12) of the South Carolina Uniform Securities Act, S.C. Code Ann. § 35-1-20(12). [2/] The pertinent text of each of the foregoing statutes is reprinted in the appendix at 36a.

STATEMENT OF THE CASE.

This case arose out of a promissory note signed by the Petitioner Darmstadter in connection with an investment in railroad boxcars. In 1978, Darmstadter was employed by National Railway Utilization Corporation ("NRUC") in its Washington office. NRUC is engaged in the business of supplying and managing railroad boxcars for itself and others. Darmstadter's responsibilities included acting as a liason with government agencies and keeping a high profile for NRUC in Washington. She owned 4% of NRUC's stock.

[2/] The South Carolina Courts have indicated South Carolina follows cases interpreting the federal securities statutes. Thus, the question of whether a security is involved in this case should require the same answer under federal and state law. Bradley v. Hullander, 272 S.C. 6, 249 S.E.2d 486 (1978).

In the fall of 1978, Darmstadter was approached by the President of NRUC with an opportunity to join a group of NRUC management and their friends who planned to invest in railroad boxcars tied to management agreements with NRUC. Financing for the boxcar investments was provided to all of the boxcar investors by Respondent The South Carolina National Bank ("SCN").

The terms of the financing, which were the same for all the investors, were primarily negotiated with SCN by certain officers and directors of NRUC. SCN had no face-to-face contact with Darmstadter or any of the individual investors regarding the financing terms. In fact, the material terms of the financing were negotiated in a June 1978 transaction of the same nature in which Darmstadter had no involvement.

On or about December 27, 1978, Darmstadter, and Twenty (20) other investors, received and executed the boxcar investment documents, which included a Bill of Sale, Management Agreement with NRUC, Agency

Agreement with SCN, and a 5½ year promissory note payable to SCN. The promissory note was collateralized by each investor's interest in his or her boxcar and management agreement. Under the investment plan, only the earnings on boxcars of investors who signed the Agency Agreement with SCN were paid into a common pool and maintenance expenses were paid out of a pooled reserve [3/]. NRUC paid the pooled earnings over to SCN's trust department. SCN's trust department then paid the debt service due on each investor's promissory note to the SCN commercial loan department. Any excess of boxcar revenue over debt service was held by SCN's trust department in escrow accounts until the investor's promissory note was paid in full. An identical transaction

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[3/] Paragraph 4.H of the Management Agreement provided: "Unless otherwise directed by Owner [the investor] NRUC shall pool the car hire and mileage revenues and expenses of the Units with the income and expenses of forty-six (46) boxcars or such lesser number as are owned by persons who have executed the Agency Agreement with South Carolina National Bank dated as of December 27, 1978." All of the investors financed with SCN and all executed the Agency Agreement.

had occurred in June, 1978, between twenty-one (21) investors, NRUC, and SCN, but Darmstadter was not a participant in that transaction. Taken together, there were twenty-seven (27) different investors who participated in either the June and/or December transactions and the total amount financed by SCN was $4,203,318.

The boxcar investments went as planned until December 1979. At that time the utilization rate of NRUC boxcars declined markedly, and the revenue from the boxcar pool became insufficient to meet the investors' debt service. In October, 1984, SCN filed its complaint in the District Court for South Carolina based on diversity of citizenship. The complaint sought to collect the balance remaining on Darmstadter's note that had not been paid by her share of boxcar revenues from the pool.

In her answer and counterclaim, Darmstadter alleged that the note at issue was a "security" either standing alone or as a part of an investment contract. She further alleged that under the equitable doctrine of

recoupment SCN was barred from enforcing the note because of state and federal securities laws violations. The basis for federal jurisdiction over the state law counterclaims was the principles of pendent and ancillary jurisdiction enunciated in Hurn v. Oursler, 289 U.S. 238 (1933) and United Mine Workers of America v. Gibbs, 383 U.S. 715 (1966). Both parties moved for summary judgment in the trial court, and, at the hearing on July 24, 1985, the parties agreed the case would be decided on the record, which at that juncture consisted of deposition testimony, exhibits, and various affidavits. On November 18, 1985, District Judge William W. Wilkins, Jr. filed an order granting SCN's motion for summary judgment. On November 26, 1985, counsel for SCN filed a sworn affidavit in support of SCN's claim for attorney's fees. [4/] Attached to the affidavit is a detailed list of the time devoted by SCN's counsel to the case and

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[4/] A copy of the affidavit with the relevant portion of the attachments is attached hereto in the appendix beginning at 38a.

the work accomplished. By this affidavit, counsel for Darmstadter first learned that counsel for SCN had, at the request of the district judge, prepared a proposed order which was submitted to the district court, ex parte.

In January, 1986, the district judge held a status conference pertaining to the appeal of the case. At that time, Darmstadter had filed her designation of the appendix with the Fourth Circuit Court of Appeals, setting forth her intention to appeal in part on the grounds of ex parte communications between counsel for SCN and the district judge. At this conference, the district judge asked counsel for SCN to forward a copy of his proposed order to counsel for Darmstadter. A copy of the cover letter and the ex parte proposed order were later made part of the record by stipulation of the parties and are included in the appendix beginning with the stipulation at

44a. [5]

In its order issued on September 4, 1986, the Fourth Circuit Court of Appeals denied Darmstadter's request for de novo review and held that the ex parte preparation and submission of the proposed order to the district judge did not require a standard of review stricter than that of Rule 52 of the Federal Rules of Civil Procedure. The Fourth Circuit Court of Appeals also affirmed the judgment of the district court, finding that Darmstadter's note to SCN was not a security because SCN's money was used in the investment and not Darmstadter's. In short, the court below found that the note was part of a

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[5] Although the Fourth Circuit found the district judge did not adopt the proposed order verbatim in his final order, the two orders speak for themselves and are virtually identical in the determinative factual findings. This is especially true with regard to two key factual findings: That the officers of NRUC who negotiated with SCN were acting as Darmstadter's agent; and, that at the time the participating members of the management group were chosen, no lender had been selected.

commercial lending transaction with a significance independent of the contract between her and NRUC and that it was not subject to securities regulation.

REASONS FOR GRANTING THE WRIT.

The initial issue raised in this case is an important procedural due process question of far greater significance than the one addressed by this Court in Anderson v. City of Bessemer City, 105 S. Ct. 1504, 1511 (1985). If the ex parte procedure condoned below is not ruled unconstitutional then future civil litigants stand to be deprived of their property by ex parte orders written by opposing counsel at the request of trial judges. This Court has never been presented with the opportunity to address this important issue because ex parte proceedings by their very nature are surreptitious. In this case the ex parte communications were only discovered fortuitously after SCN's counsel submitted his statement for services in

connection with obtaining attorneys fees under the note.

A related question is whether, under the circumstances, Darmstadter was entitled to de novo review by the court of appeals, since all of the evidence in the district court was documentary. Because the proposed order was submitted ex parte, this was an appropriate case requiring de novo review by the court of appeals. In Anderson, Justice Blackmun stated that he preferred to resolve the question of the standard of review on documentary evidence when the issue was presented before this Court. Anderson at 1516. (Blackmun, J., concurring).

The second issue in this case involves the question of when a promissory note is a security under federal securities law. The substantiality of the question raised herein is reinforced by the fact that the facts in SEC. v. W. J. Howey Co., 328 U.S. 293 (1946), were almost identical to the facts at hand but for the promissory note given to SCN by Darmstadter. If the decision below is allowed

to stand, promoters of financed investments will be able to effectively evade the securities laws by involving third party lenders who will be immune from the investor's counterclaims for offset and recoupment. This Court cannot sanction the opinion of the Fourth Circuit where there was no face-to-face negotiation between the lender and a class of investors. If the decision below is left standing, the opportunities for abuse of the federal securities laws by skillful promoters will be infinite. For these reasons, this Court should address the novel questions raised by this petition.

I.
THE DECISION BELOW IMPROPERLY EXPANDED THE HOLDING OF ANDERSON SO AS TO DEPRIVE DARMSTADTER OF THE FAIR PLAY DEMANDED BY CONSTITUTIONAL DUE PROCESS.

A. The Opinion Below Improperly Expanded The Anderson Holding Because Anderson Does Not Apply To Proposed Findings Submitted Ex Parte.

The decision below incorrectly applied the holding and rationale of Anderson v. City of Bessemer City, 105 S. Ct. 1504, 1511 (1985), to the facts at bar in finding the

Petitioner was not entitled to de novo review. In Anderson this Court recognized that in the circumstances presented in that case more stringent appellant review was not required simply because the district court had adopted proposed findings submitted by counsel. A close reading of Anderson unequivocably demonstrates it did not lay down a broad rule of law, but rather applied only to the peculiar circumstances present in that case. In Anderson:

> (1) The district court issued to both parties a brief memorandum decision setting forth its findings and requesting counsel for the successful party to submit further findings expanding on those in the memorandum.
>
> (2) The losing side was also given an opportunity to reply.
>
> (3) The final order also varied considerably in organization and content from the findings submitted by counsel.

"Under these circumstances, [this Court saw] no reason to doubt that the findings

issued by the District Court represent the Judge's own considered conclusions." Anderson at 1511. (emphasis added). However, the circumstances in Anderson are completely absent from the case at bar. In the instant case, there was no memorandum of the judge's decision. The decision was announced in an ex parte manner only to the prevailing party. The district judge requested counsel for the prevailing party to submit a proposed order. Thereafter, SCN's counsel had ex parte telephone conversations with the court. The entire arrangement was ex parte and the proposed order was submitted surreptitiously. Darmstadter's counsel had no opportunity to reply to the proposed order, since the Judge's decision was unannounced. The proposed order contained no citations to the record. The findings of fact in the order of the district court do not vary considerably in organization and content from the proposed ex parte order submitted.

The authority which this Court relied upon in the Anderson opinion makes it clear

that it did not intend the holding to be expanded far beyond its peculiar circumstances. In both United States v. Marine Bancorporation, 418 U.S. 602, 615 (1974) and United States v. El Paso Natural Gas Co., 376 U.S. 651, 656 (1964), the primary authorities relied upon by this Court in Anderson, the trial judge announced his decision from the bench. This factor was crucial to the decision in Anderson, but is completely absent from the instant facts.

Should the decision below be left standing, the fundamental rights of every litigant in federal district court will be hampered. When the trial judge's decision is announced only to the prevailing party, and the proposed order is submitted in a clandestine manner, the losing party can justifiably feel they were denied the fair play required for due process. In fact, a Fourth Circuit decision prior to Anderson found this practice amounted to a denial of constitutional due process. Chicopee Manufacturing Corp. v. Kendall Co., 288 F.2d

719, 724-25 (4th Cir. 1961). Anderson could not have been intended by this Court to eradicate the obviously just result of Chicopee. Surely the instant case presents an issue of even greater moment than that in Anderson, which did not involve an ex parte arrangement perpetrated without notice to the opposing side.

The practice of allowing ex parte preparation of orders in the federal court as now condoned by the Fourth Circuit in this case raises important constitutional issues of procedural due process which this Court should resolve.

B. Application Of The Clearly Erroneous Standard Of Review In The Court Below Was Incorrect Under The Circumstances Because All Of The Evidence In The District Court Was Documentary.

The Fourth Circuit Court of Appeals incorrectly denied de novo review because it ignored the fact that all of the evidence before the district court was documentary. The decision in Anderson involved the credibility of witnesses and did not entirely involve documentary evidence as in the instant

case. As aptly pointed out by Justice Blackmun in his concurring opinion in Anderson, this Court's opinion in Anderson is dictum with regard to findings based totally on documentary evidence. After raising the distinction between findings based on documentary evidence and creditability determinations, Justice Blackmun stated that he preferred to wait for a case where the issue must be resolved and where it has been briefed and argued by the parties rather than to address the issue at the time. Id. at 1516 (Blackmun, J., concurring). The circumstances in this case, where a proposed order was submitted ex parte and all of the evidence was documentary, entitles the Petitioner to de novo review.

Inasmuch as Justice Blackmun has specifically stated that the question raised in his concurring opinion is worthy of review, this point calls for little argument. This Court should clearly consider this fundamental question.

II.

A PROMISSORY NOTE ISSUED AS PART OF A COMMON SCHEME TO PARTICIPATE IN A POOLED INVESTMENT AMONG A CLASS OF INVESTORS IS A "SECURITY" WITHIN THE MEANING OF THE FEDERAL SECURITIES LAWS. THIS PRESENTS A SUBSTANTIAL FEDERAL QUESTION NOT HERETOFORE DETERMINED BY THIS COURT.

The Petitioner invested in an investment scheme in which she had to execute a promissory note to a prearranged lender (SCN) in order to participate in the pooled earnings of the common investment scheme. This requirement was dictated by the terms of the investment documents. If Darmstadter had paid cash for her investment and not executed the note to SCN, she could not have participated in the pooled earnings of the common enterprise. In short, the note to SCN gave the investment its utility, because the earnings on one investor's boxcar when pooled directly paid another investor's note. The district judge's opinion failed to recognize the option to forego pooling of earnings with other investors (for which financing with SCN was required) was an illusory option, since the boxcar investment had utility only in a

pooling arrangement. The Fourth Circuit panel ruled (without supporting reasoning) that Darmstadter's note to SCN was a commercial lending transaction with a significance independent of the investment contract between Darmstadter and NRUC. 6/

However, the primary authority relied on by the Fourth Circuit, SEC v. W. J. Howey Co., 328 U.S. 293 (1946), compels the opposite conclusion. In Howey, this Court found that land sales contracts, warranty deeds, and service contracts were component parts of an

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6/ Whether a promissory note issued as part of a common investment scheme is a security has never been determined by this Court. In fact, while the various circuits have enunciated different tests with regard to when a promissory note is a security, this Court has never specifically addressed that issue. See Futura Development Corp. v. Centex Corp., 761 F.2d 33 (1st Cir.), cert. denied, 106 S. Ct. 147 (1985), which outlines the various tests applied by the different circuit courts of appeal. In the instant case, the note is a security under any test because it is an integral component of an investment contract. There is clearly: (1) An investment of money, [See note 7, infra.] (2) A common enterprise, and (3) As the Fourth Circuit found, an expectation on the part of the investors that boxcar revenues would exceed their obligations to SCN. See 6a of the appendix.

integrated arrangement which had utility only when offered to investors as a single investment contract. Id. at 300. The Fourth Circuit distinguished Howey from the instant facts based on the fact that SCN's money was used in the investment rather than Darmstadter's. Under the Fourth Circuit's decision, if the investors in Howey had executed notes to a prearranged third party lender in a common scheme, the investors would have no defense against the lender under the federal securities laws when the lender sought to collect on the notes. It is inconceivable that Howey could so easily be avoided by simply bringing in a third party lender as part of a common investment scheme.

Asserting securities violations defensively by way of recoupment is of major importance to investors. See, e.g., General Life of Missouri Investment Co. v. Shamburger, 546 F.2d 774 (8th Cir. 1976), where an investor successfully defended a suit on a subscription agreement ten (10) years after the original transaction. In a financed

investment, the investor would have no reason to seek affirmative relief until the payee of the note seeks to enforce it. By that time, the investor has no recourse against the promoter. (The lender may also have committed a securities violation which could not be asserted against the promoter). If the decision below is allowed to stand, ingenious securities promoters will be given wide latitude to circumvent the securities laws by financing their transactions with third party lenders rather than financing such transactions themselves as is frequently the case.

The opinion of the Fourth Circuit panel turns entirely on the fact that SCN supplied the money for the transaction rather than Darmstadter. 7/ It ignores the fact that Darmstadter's capital is placed at risk, and that Darmstadter as an investor was the person intended to be protected by the securities

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7/ Under the Fourth Circuit's rationale, if the promoter in Howey had financed the investment by taking the (footnote continued)

laws. Due to the direct payment of earnings from NRUC to SCN and the escrow arrangement, Darmstadter's reasonable expectation was that she would in fact be the "payee" of the escrowed earnings at the end of five and one-half (5½) years. As stated by this Court in Howey, the concept of a security is "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." Id. at 299. If NRUC had borrowed direct from SCN to buy the

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7/ (continued) investor's note, the investment would not be a security because in that case the promoter would have furnished the money and not the investor. Analogous to the Fourth Circuit's opinion, the term of the note would merely reflect the time the promoter had placed his money at risk as opposed to the investor's capital. Carried to its logical conclusion, no financed investment would be a security under the Fourth Circuit's opinion. However, as a matter of common sense, the phrase "an investment of money" in the Howey test cannot be read literally. It clearly contemplates only that an element of financial risk to the investor must be present without creating a dividing line between "cash" and "financed" investments. The investor who signs the note unquestionably bears the risk of the investment.

boxcars and then resold the boxcars to Darmstadter who issued her note to NRUC, there is no question that Darmstadter's note to NRUC would be part of the investment contract and voidable upon a finding of securities laws violations. To allow NRUC to arrange the note from Darmstadter to SCN and thereby remove it from the scope of the securities laws is an inflexible interpretation of such laws not intended by Howey.

While the instant facts present a complicated investment scheme, this is the very situation which this Court addressed in Howey. The Court in Howey recognized that it could not envision every conceivable investment scheme, and as a result stated that the definition of a security is a flexible principle that is capable of adaptation. The court below, however, ignored this key part of the Howey decision and applied the case literally. While we realize that this Court in Howey did not intend the securities laws to provide a remedy for all fraud, the facts in this case fall clearly within the scope of

Howey. Should the decision below be left standing, the rights of millions of investors will be sharply curtailed by skillful promoters engaging third party lenders as part of an investment scheme. This we submit raises one of the most important questions of federal securities law since the Howey decision was rendered forty (40) years ago.

We are not unmindful that a similar issue was presented in a petition for certiorari filed in Davis v. Avco Financial Services, Inc., 739 F.2d 1057 (6th Cir. 1984), cert. denied, 105 S. Ct. 1359 (1985). However, in Avco, the investor and the third party lender engaged in face-to-face one-on-one negotiation. In the instant case, the investors and SCN had no face-to-face negotiation. The entire financing arrangement was prearranged by the promoter of the investment and the terms of the financing were the same for all investors. Furthermore, all of the investors in the instant case invested in the transaction contemporaneously, and only those who financed with SCN were able to

participate in the pooled earnings arrangement. As a result, the earnings on one investor's boxcar went to pay another investor's note.

In Marine Bank v. Weaver, 455 U.S. 551 (1982), this Court noted that instruments found to constitute securities in prior cases involved offers to a number of potential investors and not transactions negotiated face-to-face. Id. at 560 n. 10. This distinction, based on the lack of face-to-face dealing, has been found significant in numerous other cases. Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1262 (9th Cir. 1976); Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 938 (2d Cir.), cert. denied, 105 S. Ct. 253 (1984); Underhill v. Royal, 769 F.2d 1426, 1431 (9th Cir. 1985); Roarke v. Belvedere, 1986 Fed. Sec. L. Rep. (CCH) ¶92,538 (S.D. Ohio 1985). In the instant case, twenty-one (21) investors invested in a simultaneous investment, each signing the same investment documents, and each having an interest in the pooled earnings of the

investment. Each of the investors signed a note to SCN as part of the investment, and none of the investors had face-to-face dealings with SCN. This raises an important distinction between the instant facts and every case relied on by the Fourth Circuit. However, the Fourth Circuit blatantly ignored this distinction, and addressed the issue as if the note in question were part of a single isolated transaction between Darmstadter and SCN.

The face-to-face distinction set forth by this Court in Marine Bank raises a fundamental question of federal securities law that this Court has never been called upon to decide. If transactions with unseen parties are treated the same as those negotiated face-to-face, an important objective of the federal securities law will be frustrated. For this reason, the Court should consider this substantial and important federal securities law question.

A writ of certiorari should issue to the Fourth Circuit Court of Appeals because it has

substituted its policy judgment for that indicated by prior decisions of this Court. If the decision below is allowed to stand, it will circumvent a fundamental objective of the federal securities laws.

CONCLUSION.

This Court should grant certiorari, the Petitioner is entitled to de novo review, and the judgment below should be reversed.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 85-2198(L)

The South Carolina National Bank,

Appellee,

versus

Virginia L. Darmstadter,

Appellant.

No. 86-1549

The South Carolina National Bank,

Appellee,

versus

Virginia L. Darmstadter,

Appellant.

Appeal from the United States District Court for the District of South Carolina, at Greenville. William W. Wilkins, Jr., United States District Judge. (84-2466-14).

Argued: June 4, 1986 Decided: Sept. 4, 1986

Before HALL, MURNAGHAN and SPROUSE,
Circuit Judges.

James R. Gilreath (H. Mark Emanuel; Law Offices of James R. Gilreath, P.A. on brief) for Appellant; Jennings L. Graves, Jr. (Love, Thornton, Arnold & Thomason on brief) for Appellee.

PER CURIAM:

Virginia L. Darmstadter appeals from the district court's grant of summary judgment to the South Carolina National Bank (SCN). SCN brought this diversity action to collect on a promissory note which Darmstadter gave SCN in exchange for a loan. Darmstadter, who used the loan to finance her investment in a venture involving the purchase of railroad boxcars, counterclaimed alleging that the note was a security and that SCN had violated federal and South Carolina securities laws and fiduciary duties imposed by state law. On cross-motions for summary judgment, the district court found that the promissory note was not a security, and thus not subject to federal or state securities regulation, and that SCN had not violated its fiduciary duties. The district court granted SCN's motion for summary judgment and awarded it

$60,975.83 on the note, $6,074.58 in attorneys' fees, and $712.29 in collection fees. We affirm.

I.

The genesis of this case was in Darmstadter's purchase of two railroad boxcars through an investment venture organized by the National Railroad Utilization Corporation (NRUC). Darmstadter's involvement with NRUC dates back at least to 1972 when she inherited a large block of NRUC stock from her husband. NRUC, a South Carolina corporation, supplied and managed boxcars for its own account and for others, assembled and sold general purpose boxcars, and operated short-line railroads. When Darmstadter experienced financial difficulties in 1977, she contacted NRUC President John Rees about selling her stock. Rees advised her not to sell the stock and offered her a position, which she accepted, at an annual salary of $16,000 as director of the Washington, D.C. office which NRUC was planning to open.

During 1977, NRUC developed the concept of selling boxcars to its management personnel and stockholders and, on four occasions from December 1977 to June 1979, made boxcars available for purchase by those individuals. Under each purchaser's agreement with NRUC, NRUC managed, maintained and arranged for utilization of the boxcars. The purchaser had essentially a passive role in the management of the boxcars. NRUC also arranged financing for each individual's purchase of boxcars. NRUC negotiated with Citicorp Leasing to provide financing for the first venture in December 1977. It arranged for SCN, with which it had a long-standing relationship, to provide financing for the second and third ventures in June 1978 and December 1978, respectively. New England Merchants Bank provided financing for the fourth venture in June 1979.

Darmstadter participated in the December 1978 and June 1979 ventures.[1] She borrowed ninety percent of the purchase price of two boxcars from SCN to finance her participation in the December 1978 venture, and it is that loan which is the subject of this appeal.[2] Darmstadter executed a five and one-half year promissory note payable to SCN which was collateralized by her investment in the boxcars and the management agreement with NRUC. She also executed an agency agreement with SCN under which NRUC pooled her earnings on the boxcars with those of other purchasers who signed such agreements. After deducting maintenance expenses, NRUC transferred these pooled earnings to SCN's trust department. The trust department then paid the debt service due on Darmstadter's promissory note

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[1] Darmstadter's participation in the June 1979 venture, which New England Merchants Bank financed, is not relevant to this appeal.

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[2] Darmstadter also borrowed her downpayment on the boxcars from SCN through a 29-day consumer note.

to SCN's commercial loan department and held any excess revenue above debt service in an escrow account until her promissory note was due at the end of five and one-half years.

The purchasers' expectations apparently were that boxcar revenues would exceed their obligations to SCN. A sharp drop in the utilization rate for NRUC boxcars beginning in late 1979, however, upset expectations. Revenues fell below debt service requirements, and SCN sought recovery from the individual purchasers. When Darmstadter refused to pay on her note, SCN brought this action.

II.

Darmstadter argues on appeal that federal and state securities laws are applicable to her transaction with SCN and that SCN violated those laws.[3] Section 12 of the Securities Act

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[3] Darmstadter also asserts that the district court, apparently ex parte, erred in asking SCN to prepare a proposed order of findings and conclusions granting summary judgment to SCN. The court then used SCN's proposal as the basis of its own order. Darmstadter argues that we should not (footnote continued)

of 1933, 15 U.S.C. § 771, section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and section 35-1-1490 of the South Carolina Uniform Securities Act, S.C. Code Ann. § 35-1-1490, require the disclosure of all material facts in connection with the purchase or sale of a security. The federal and state statutes define a "security" to include a "note." 15 U.S.C. §§ 77b(1), 78c(a)(10); S.C. Code Ann. § 35-1-20(12). Not every note, however, is a security under these statutes. See United Housing Foundation v. Forman, 421 U.S. 837, 849 (1975); Futura Development Corp. v. Centex Corp., 761 F.2d 33, 38-39 (1st Cir.), cert. denied, 106 S.Ct. 147 (1985). Courts look to the economic

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3 (continued) apply the clearly erroneous standard of Rule 52 of the Federal Rules of Civil Procedure and should remand the case for further proceedings. The district court, however, did not adopt SCN's proposed findings verbatim. Even if it had, that action appears proper under the recent Supreme Court holding that "even when the trial judge adopts proposed findings verbatim, the findings are those of the court and may be reversed only if clearly erroneous." Anderson v. City of Bessemer City, 105 S. Ct. 1504, 1511 (1985).

realities of the transaction, not the name given to the instrument, to determine if, in fact, a note is a security within the meaning of the statutes. See Forman, 421 U.S. at 849.

A number of tests have evolved for analyzing these economic realities. Futura Development Corp., 761 F.2d at 40-41. The Second Circuit interprets the language of the securities acts to require that the court presume a note to be a security and exempt it only if the context requires otherwise. Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1137-38 (2d Cir. 1976), modified, Chemical Bank v. Arthur Andersen & Co., 726 F.2d 930, 936-39 (2d Cir.), cert. denied, 105 S.Ct. 253 (1984). The Sixth and Ninth Circuits look to see whether a transaction more closely resembles a loan or has the risk factors associated with the investment of "risk capital." Union Planters National Bank v. Commercial Credit Business Loans, 651 F.2d 1174, 1182 (6th Cir.), cert. denied, 454 U.S. 1124 (1981); Great Western Bank & Trust v. Kotz, 532 F.2d

1252, 1257 (9th Cir. 1976). Other circuit courts of appeals employ the investment/commercial test which focuses on whether a transaction more closely resembles typical investment situations or typical mercantile or commercial transactions. Futura, 761 F.2d at 40-41. The criteria used by these courts includes "the size of the offering; whether there is, by necessity, reliance on the expertise of the issuer; the purpose of the issuer in executing the note and the payee in accepting the note; and the economic inducements held out to the prospect." Id. at 41 (citations omitted).

Under none of these tests is Darmstadter's note a security. SCN, in providing the loan in return for the note, was not relying on the expertise of the issuer, Darmstadter. The Bank accepted her note to secure the repayment of the loan. Repayment, however, was not conditioned upon the success of the use to which Darmstadter put the loan proceeds. The Bank was entitled to repayment regardless of the outcome of the boxcar

venture. The note provided for a fixed rate of interest and payments in fixed amounts on fixed dates. It is apparent that the Bank did not acquire the note as an investment, nor did it risk capital beyond the risk inherent in many commercial loans.

Darmstadter argues, however, that her note was not executed pursuant to a normal commercial transaction in which the party seeking to borrow money initiates the transaction. SCN, she asserts, provided at least some of the impetus for the transaction. She is no doubt correct that SCN's willingness to make the loan facilitated the boxcar investment plan which NRUC had developed. It is also true that NRUC and SCN had a long-standing relationship prior to any of the boxcar ventures. These facts, however, do not change an obvious commercial loan into a securities transaction.

In our review, of course, we are guided by the underlying purpose of the federal securities laws: to protect against fraud in "the countless and variable schemes devised by

those who seek the use of the money of others on the promise of profits." SEC v. W. J. Howey Co., 328 U.S. 293, 299 (1946). Here, Darmstadter sought to use SCN's money--not the reverse. She urges, however, that because the note had a repayment period of five and one-half years, her risk of loss under that note supports a determination that the note was a security. That argument ignores the fact that the term of the note represents the period for which the money which SCN loaned to Darmstadter is at risk.

Darmstadter's dealings with NRUC may very well constitute an investment contract subject to securities regulation. See 15 U.S.C. §§ 77b(1), 78c(a)(10); SEC v. W. J. Howey Co., 328 U.S. 293 (1946). The note which Darmstadter issued to SCN, however, is so clearly a part of a commercial lending transaction with a significance independent of the contract between her and NRUC that it is not subject to securities regulation.

In view of the above, the decision of the

district court is affirmed.

AFFIRMED.

THE SOUTH CAROLINA NATIONAL BANK,
Plaintiff,

v.

VIRGINIA L. DARMSTADTER,
Defendant.

Civ. A. No. 6:84-2466-14.

United States District Court,
D. South Carolina,
Greenville Division.

Nov. 18, 1985.

ORDER

WILKINS, District Judge.

This matter is before the Court upon the parties' motions for summary judgment. For the reasons set forth below, the Court finds that the December 1978 loan transaction between the parties does not involve or constitute a security. Further, the Court finds that Plaintiff was not a responsible party in the transaction between Defendant and the National Railway Utilization Corporation (NRUC) in that Plaintiff did not breach any fiduciary duty owed Defendant. Accordingly, Plaintiff's motion for summary judgment on these issues is granted. The remaining issues

contained in Plaintiff's motion and Defendant's motion for summary judgment are denied.

The threshold question to be addressed is whether the loan of Plaintiff, The South Carolina National Bank (SCN), to Defendant and the receipt by SCN of a secured note from Defendant in December 1978 constitute a security. If the secured note received by SCN in exchange for the loan, in the context of the overall transaction, and in the context of the intent of the federal and state securities laws, is a security, additional questions would arise; but if the loan transaction does not involve a security, the Court need not further consider Defendant's allegations of securities violations. A related question which must be addressed, although summarily, is whether SCN's financing of Defendant's investment transaction with NRUC implicates SCN in the issuance, sale or purchase of a security by NRUC. If the loan transaction does not involve a security, the remaining issues for the Court are Defendant's

allegations of breach of fiduciary duty and the amount of damages, if any, due the prevailing party.

FINDINGS OF FACT

The transaction in question originated December 27, 1978 when Defendant purchased two railroad boxcars pursuant to a business venture with NRUC. Defendant financed the purchase price by receiving a secured loan from SCN, and SCN secured the loan with the assets purchased and all of Defendant's rights arising thereunder. An earlier identical transaction occurred in June 1978.

During 1978 NRUC was engaged in, among other things, the business of supplying and managing general purpose railroad boxcars for its own account and for others to be used in the railroad interchange system. NRUC was and continues to be a common carrier subject to regulation by the Interstate Commerce Commission. NRUC's corporate headquarters and executive offices were and are located in Philadelphia, Pennsylvania. In December 1978

Defendant was the eighth largest stockholder in NRUC. Defendant was employed as the director of the Washington, D.C. office of NRUC in September 1977.

During 1977 the concept of the sale of railroad boxcars to individual owners and the management of those boxcars by NRUC originated within the management of NRUC. As the development of the managed boxcar concept progressed, certain members of NRUC management realized that an investment in boxcars to be managed by NRUC might be an attractive fringe benefit for NRUC management, stockholders and other insiders. However, during the period of 1977 and 1978, the demand for boxcars far exceeded the supply and the number of boxcars available for purchase by what came to be known as the "management group" was limited.

Defendant attacks the loan transactions which accompanied the sales of boxcars to Defendant and other members of the management group in June and December of 1978, but attempts to escape liability under only the December 1978 note. The sales transactions

involved duplicate sets of documents, which included a Secured Note, Security Agreement, Agency Agreement, and Management Agreement. Several members of the management group negotiated the terms of the purchases and of the management of the boxcars and also arranged for loans for individual members of the management group from commercial lenders. SCN was one of several lenders approached regarding loans and at least one other bank was prepared to make loans to the management group. At the time that the participating members of the management group were chosen, no lender had been selected. It is clear that the impetus for the loan transactions came from Defendant's fellow members of the management group, and not from SCN. It is also clear that the terms of the loans were negotiated on behalf of the individual members of the management group by fellow members of the management group.

Likewise, the purchases of the boxcars, including the price, and the terms of the Management Agreement, including management

duties and management and maintenance fees, between NRUC and the purchasers, were negotiated directly between NRUC and the management group thereof. NRUC and the management group determined that the revenues earned by the boxcars should be pooled in order to provide each of the members of the management group with equal treatment. The Management Agreement also provided that any member of the management group could elect to withdraw from the pooling arrangement at any time. Further, the agreement provided that the management and maintenance fees payable to NRUC would not be paid if revenues were insufficient to first pay the loan installments to SCN. SCN did not establish the terms of the purchase and management documents between the individual members of the management group and NRUC. SCN's involvement in the overall transaction was limited to the structuring of the financing of the transaction and the documents establishing and/or affecting the financing.

SCN loaned the individual members of the management group 90% of the purchase prices of the boxcars. As a secured lender, SCN participated in the structure of the loans and collateral documents. SCN required that each of its loans be collateralized and took security interests in the boxcars purchased, and in the revenues generated by the boxcars and the individual borrowers' contract rights under the Management Agreement with NRUC. The Court is aware that commercial lenders often play an active role in the determination of the terms of any loan documentation and in the terms of collateral documentation, with particular concern toward protection of the lender's position. The participation of SCN in the loan transactions herein demonstrates that it, to the extent that the superior bargaining power of any lender allows, dictated the terms of the notes and related agreements, including specific terms concerning the collateral.

The Secured Note issued by Defendant to SCN in exchange for the loan from SCN provided

for a fixed principal amount, interest fixed at the rate of 12% per annum, fixed periodic principal and interest payments, and a fixed balloon payment in July 1984. The note and security agreement also provided for standard default terms, for acceleration in the event of default and for attorney's fees and costs of collection in the event that legal action was necessary. SCN further required that its collateral be properly insured and required financial statements from the borrowers prior to the closing of the loan transactions, and on an annual basis thereafter. SCN made a determination that certain of the borrowers in the management group were required to provide additional collateral, in addition to the boxcars and the proceeds of the boxcars. The note further provided that the borrower could prepay the note in full anytime upon the payment of a prepayment fee amounting to 3% of the then outstanding loan balance.

The Agency Agreement between each individual borrower and the SCN Trust Department provided that NRUC, once it

allocated the revenues to the individual boxcar owners, would pay the net revenues to the SCN Trust Department and further provided that the SCN Trust Department would, to the extent that funds were available in the account of each individual borrower, make the quarterly principal and interest payments to the SCN commercial loan department. Any excess revenues were to be invested in a consumer passbook savings account for the benefit of each investor, and were to be retained in the savings account until the loan was paid in full. Each individual borrower was to be responsible, however, for any deficiency in the quarterly principal and interest payments. SCN therefore acted as an escrow agent for the collection of revenues, application thereof to the debt and retention of excess revenues. SCN received a deposit of $4,000.00 per boxcar toward the purchase of each boxcar.

A careful review of the Secured Note of Defendant demonstrates that the quarterly principal and interest payments were

determined on the basis of a 12-year amortization schedule and that the full remaining balance on the note was due to SCN five and one-half years after funding. Obviously, there would remain a substantial balloon payment due at maturity of the Secured Note, and SCN required as security for the full amount of the note that the revenues generated by the boxcars, to the extent that the revenues exceeded the quarterly principal and interest payments, be retained in an escrow savings account. While this feature may not accompany every commercial loan, it is consistent with SCN's desire to be as fully protected as possible, particularly in light of the balloon payment feature of the note. Defendant contends that this structure evidences the intent by SCN to participate in the profits to be derived solely from the efforts of others, but logic and common sense dictate that such was more likely the action of a prudent lender attempting to protect its loan repayment as securely as practicably possible. Other than rights to its collateral

and to repayment in accordance with the terms of the financing documents, SCN had no right to control NRUC or Defendant and had no right to share in the profits of either.

Further, there is no evidence of any role played by SCN in inducing Defendant to purchase the boxcars.

CONCLUSIONS OF LAW

The definitions of "security" under the Securities Act of 1933, 15 U.S.C.A. § 77b(1) (West Supp. 1985), and the Securities Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(10) (West Supp. 1985), as well as under the South Carolina Blue Sky Laws, S.C. CODE ANN. § 1-20(12)(Law. Co-op. 1976 & Supp. 1984), are essentially identical and provide that the term "security" includes any note unless the context otherwise requires.

Where the South Carolina securities law is substantially identical to the federal provisions, South Carolina courts will ordinarily follow the federal court's interpretations of federal securities laws.

Bradley v. Hullander, 272 S.C. 6, 249 S.E. 2d 486, 494 (1978). Since South Carolina courts have not construed the term "security" and the term "note" within the context of a security, a discussion must necessarily deal with the federal securities laws.

The Fourth Circuit Court of Appeals utilized the following definition in determining whether a note constituted a security in Lawler v. Gilliam, 569 F.2d 1283, 1287 (4th Cir. 1978):

> In United Housing Foundation, Inc. v. Forman, 421 U.S. 837, 852 [95 S.Ct. 2051, 2060, 44 L.Ed. 2d 621] (1975), the Court, reviewing its decisions that have examined the statutory definition of a security, said: "The touchstone is the presence of an investment in a common venture premised on a reasonable expectation of profits to be derived from the entrepreneurial or managerial efforts of others."

Although the Fourth Circuit has yet to characterize the test it uses in considering the constitution of a "security," this language indicates that the Fourth Circuit would adopt the "commercial vs. investment" test employed by the First, Third, Fifth, Seventh and Eleventh Circuits. Oliver v.

Bostetter, 426 F.Supp. 1082, 1085 (D. Md. 1977). Factors to consider in determining whether a given commercial instrument constitutes a security include:

> [T]he size of the offering; whether there is, by necessity, reliance on the expertise of the issuer; the purpose of the issuer in executing the note and the payee in accepting the note; and the economic inducements held out to the prospect[;] ... the degree to which the profit on the note is in the hands of the maker rather than the payee; whether the object of the holder was to acquire an interest in the property or enterprise; whether the note was primarily commercial because it was serving as a "cash substitute" for the purchase price; and whether the return on the note was predetermined or could reasonably be anticipated, or was subject to the managerial efforts of the maker.

Futura Development Corp. v. Centex Corp., 761 F.2d 33, 41 (1st Cir. 1985). All of these factors should be considered in their combined effect to determine the constitution of a particular transaction. See Amfac Mortgage Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d 426, 432 (9th Cir. 1978).

The facts of this case establish that the loan transactions did not constitute or involve securities. First, Defendant could

have obtained alternative financing for the purchases or could have paid for the boxcars in cash. Second, the notes herein were issued by Defendant within the context of a commercial loan transaction and not within the context of a "purchase" of a security by SCN. The loan was represented by a promissory note and related documents, providing SCN with collateral in all of Defendant's rights in the assets purchased, including the right to income earned by the assets. The note was for a fixed sum and provided for interest at a fixed rate and for payments in fixed amounts and at fixed dates. It contained standard default provisions, including the right to accelerate the due date of payments upon default, and to pursue the borrower and the collateral in the event of default. SCN's requirement that it retain any excess revenues during the term of the note was reasonable within the context of the security concerns of a commercial lender, given the balloon payment feature of the note. Moreover, the note provided that Defendant could prepay the debt

at any time, thereby avoiding the requirement that SCN hold any excess revenues earned.

Further, SCN did not look to the managerial or entrepreneurial abilities of NRUC or to the success of Defendant's investment for repayment. It analyzed the credit position of Defendant prior to the loan transaction and determined that she had sufficient assets for repayment of the loan, aside from her purchase of the boxcars. Defendant was also specifically responsible for any deficiency in the quarterly payments.

The facts that SCN could potentially use any excess revenues it held in its passbook savings account for bank purposes and that SCN received a fee for its escrow functions does not turn this otherwise commercial loan into an investment by SCN. Every loan transaction, savings account system, or banking function of a commercial bank constitutes a form of investment, in that the bank will receive some form of profit or remuneration in return for its services, such as interset, the use of funds deposited, or fees. See Futura

Development Corp. v. Centex Corp., 761 F.2d at 41-42; Thorp Commercial Corp. v. Northgate Industries, Inc., 1974-1975 Fed. Sec. L.Rep. (CCH) ¶ 94,929. In the present case SCN's right to the interest earned or to the use of any funds on deposit was subject to the borrower's right to prepay the loan, thereby detracting from any investment purpose of SCN. The purpose of the present loan was to provide Defendant with the necessary funds to utilize in a business venture. SCN did not induce Defendant to undertake the venture, as SCN was not selected as the financing institution until after the decision to invest was made, SCN was one of several institutions considered, and Defendant was a majority shareholder of the corporation with which she entrusted her funds. SCN was not attempting to participate in the boxcar venture, as it merely supplied the cash for an investment and received tailor-made security in return therefor. Indeed, Defendant could have financed the transaction by the use of another lender or by the payment of cash. Last,

regardless of whether the subordination of NRUC's fees was the result of SCN's demands or of NRUC's drafting, this factor when considered in the totality of the circumstances does not render the loan transaction a security.

Several courts have addressed the issue of whether a note or loan transaction constitutes a security in factual situations somewhat similar to the one present here. One of these factual situations is found in Davis v. Avco Financial Services, Inc., 739 F.2d 1057, 1063 (6th Cir. 1984). In Davis, the Sixth Circuit held, inter alia, that promissory notes executed to a finance company in the ordinary course of the finance company's business, the proceeds of which were to be used to pay for an investment in a "Dare to Be Great" pyramidal scheme, were not securities. Further, in Amfac Mtg. Corp. v. Arizona Mall of Tempe, Inc., 583 F.2d at 433, the court held, under a test somewhat different from that used in this circuit, that a promissory note and related security

documents received by a finance company to finance the borrower's investment in the construction of a shopping center were not securities under the federal securities laws. The court recognized that federal securities laws do not afford relief when commercial ventures prove to be unwisely made. Id. at 428. See also Futura Development Corp. v. Centex Corp., 761 F.2d at 38-42, Thorp Commercial Corp. v. Northgate Industries, Inc., 1974-1975 Fed. Sec. L.Rep. (CCH) ¶ 94,929.

Further, the Fourth Circuit's opinion in Lawler v. Gilliam, 569 F.2d at 1287, is supportive of the conclusion that the present loan transaction did not involve or constitute a security. The Court in Lawler held, inter alia, that promissory notes issued by a business, in exchange for investments of money, which were accompanied by contracts guaranteeing a specific rate of return on the investment, and which were used as collateral for bank loans, constituted securities. Although not specifically addressed, the Court

did not treat the bank loan transactions which provided the funds to invest as securities. Applying Lawler to the present case, the management agreement and related agreements which Defendant entered into with NRUC are analogous to the notes and guarantee contracts that the investor received in Lawler, as both constituted investments dependent upon the managerial skills of third parties, and both were used as collateral for bank loans. However, the bank loans providing the funds with which to invest were not treated as securities in Lawler, and are not securities in the present case. Accordingly, the Court finds that the loan transaction between SCN and Defendant did not constitute or involve a security as defined in state or federal securities laws.

Because the loan transaction accompanied a more complicated investment scheme, the Court must address SCN's involvement in the overall transaction between Defendant and NRUC. The Court finds that SCN is not liable as a participant in the sale of securities or

investment contracts by NRUC to Defendant. Defendant's attempt to taint SCN with the characteristics of the transaction between Defendant and NRUC is unavailing. While the Court acknowledges that SCN necessarily became involved in the transaction between Defendant and NRUC to the extent necessary to fully document and protect its loans and collateral, there is no evidence that SCN thereby intended to be making an investment or that it took any steps to induce any investment by Defendant with NRUC. Defendant has overlooked the role played by her peers in the management group at NRUC and has attempted to blame SCN for her reliance upon her associates in the management group. Further, the Court notes that Defendant was a majority shareholder of the managing agent, NRUC, and that Defendant was an educated, sophisticated businessperson well within her area of business expertise. The securities laws were not intended to relieve sophisticated investors of ill-conceived investments.

In Getz v. Central National bank of Greencastle, 147 Ind. App. 356, 261 N.E.2d 81, 85 (1970), the court ruled that the involvement of the bank, which was in many ways similar to SCN's position here, "did not constitute direct or indirect participation in the distribution" of an investment contract. This Court is persuaded by the conclusions drawn by the court in Getz, which, while it dealt with this issue as opposed to the issue of whether the note issued by the borrower to Central National Bank was a security, uses a similar approach in determining that the lender was not a participant in the distribution of an investment contract. In light of the court's finding that a commercial lender, by agreeing to perform its normal banking functions, cannot be classified as a participant in the sale of a security, the Court concludes that SCN's role in the overall transaction was that of a lender and not an investor or participant in the distribution of investment contracts or securities.

The Court must next address the Defendant's claims of breach of fiduciary duties. Defendant contends that SCN "agreed and purported to hold Defendant's equity and interest in the investment for the benefit of Defendant" and that SCN "had statutory and common law fiduciary duties to protect and promote Defendant's equity and interest in the investment on behalf of Defendant." (Answer and Counterclaim ¶ 37.)

The Secured Note and the Security Agreement provided only for the provisions concerning the loan and collateral for the loan. The Court notes that the evidence submitted clearly shows that SCN fulfilled any fiduciary obligations which may have arisen under these documents, as SCN dealt fairly and responsibly in an arm's length loan transaction with a sophisticated borrower. The only duties of SCN, other than the duties of a secured lender, were set out in the Agency Agreement. The Court finds that the evidence clearly establishes that SCN fulfilled its duties under the Agency

Agreement and that no breach of duty occurred thereunder. The materials submitted unquestionably establish that SCN did not breach any duties owed Defendant.

Accordingly, the Court grants Plaintiff's motion for summary judgment as to the issues of whether the December 1978 loan transaction constituted or involved a security, whether SCN was a responsible participant of the overall transaction, and whether SCN breached any fiduciary duties owed Defendant. Plaintiff's other grounds and Defendant's motion for summary judgment are accordingly denied.

The Court will address the issue of damages in a later order. The parties are directed to file any submissions on the issue of the amount Plaintiff is due under the note no later than December 2, 1985.

AND IT IS SO ORDERED.

STATUTES

§ 2(1) of the Securities Act of 1933 (codified as amended at 15 U.S.C. § 77b(1)) reads in pertinent part:

> Sec. 2. When used in this title, unless the context otherwise requires--
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, . . .

§ 3(a)(10) of the Securities Exchange Act of 1934 (codified as amended at 15 U.S.C. § 78c(a)(10)) reads in pertinent part:

> Sec. 3(a) When used in this title, unless the context otherwise requires--
> . . . .
>
> (10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract . . .

S.C. Code Ann. § 35-1-20(12) reads in

pertinent part:

> When used in this chapter, unless the context otherwise requires:
>
> . . . .
>
> (12) "Security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate of subscription, transferable share, investment contract, . . .

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF SOUTH CAROLINA

GREENVILLE DIVISION

The South Carolina National Bank,	)	
Plaintiff,	)	
-vs-	)	C/A No. 6:84-2466-14
Virginia L. Darmstadter,	)	
Defendant.	)	
STATE OF SOUTH CAROLINA	)	
	)	AFFIDAVIT
COUNTY OF GREENVILLE	)	

PERSONALLY appeared before me, Jennings L. Graves, Jr., who, first being duly sworn, states and says as follows:

I am a partner in the law firm of Love, Thornton, Arnold & Thomason. This firm has represented The South Carolina National Bank in the above matter since the first efforts by The South Carolina National bank to effect collection on the loan account. Attached to this Affidavit are statements of the legal fees incurred by The South Carolina National bank in this matter and the costs and expenses incident upon such legal proceedings. I have

reviewed the statements, and I hereby certify that all matters therein were reasonable efforts towards collection of the account, including the efforts in opposition to the matters raised by the Defendant by way of counterclaim.

SO SAITH THE AFFIANT.

s/ Jennings L. Graves, Jr.

SWORN to before me this

26th day of November, 1985.

s/ Peggy J. Lathan (SEAL)
Notary Public for South Carolina

My commission expires: 7/20/92

[Letterhead of Love, Thornton, Arnold & Thomason]

S. C. National Bank (CONTINUED)
SCN v. Darmstadter

11/21/85
83-0289Q

SCN v. Darmstadter

		HOURS
07/17/85		
JLG	Receipt and review of information re summary judgment	2.70
JLG	Telephone conferences with Bill Kehl and Buddy Reynolds	.30
07/18/85		
JLG	Legal research and preparation of motion re summary judgment	7.20
LC	Legal research as to securities	2.00
JLG	Telephone conference with Buddy Reynolds	.10
07/19/85		
JLG	Legal research re summary judgment; Preparation of motion; Telephone conference with Bill Kehl; Telephone conference with Judge Wilkins; Telephone conference with Jim Gilreath	5.00
JLG	Telephone conference with Bill Kehl	.20
07/20/85		
JLG	Conference with Bill Kehl; Preparation of summary judgment	8.75
JLG	Preparation of	

[Letterhead of Love, Thornton, Arnold & Thomason]

S.C. National Bank (CONTINUED)
SCN v. Darmstadter

		summary judgment	9.75
07/23/85			
	JLG	Preparation of summary judgment	9.00
	LC	Making deliveries and copies of affidavits, etc. to be refiled; Assisted with copying and filing of pleadings with clerk	2.50
07/24/85			
	JLG	Preparation for and argument re summary judgment	3.00
07/30/85			
	JLG	Preparation of presentation to Judge Wilkins	.50
08/03/85			
	JLG	Legal research at law school	2.25
08/05/85			
	JLG	Legal research re non-jury presentation	6.50
08/06/85			
	JLG	Long Distance call to David C. Humphreys, call to Charles P. Cecil, memorandum and affidavits to court	6.00

[Letterhead of Love, Thornton, Arnold & Thomason]

S.C. National Bank (CONTINUED)
SCN v. Darmstadter

08/07/85			
	JLG	Preparation of presentation to judge	11.00
08/08/85			
	JRD	Long distance call to law school, Southlaw legal ease regarding Statute of Limitations	1.00
	JLG	Preparation of submission to judge	9.00
08/09/85			
	JRD	Letter to Hayne at Legal-Ease with check	.10
08/15/85			
	JLG	Review of Defendant's Brief, letter to Attorney Kehl and Judge Wilkins	.80
08/30/85			
	JLG	Telephone conference with Judge Wilkin's Clerk	.30
09/04/85			
	JLG	Preparation of proposed Order	1.50
09/05/85			
	JLG	Preparation of proposed Order	10.00
09/06/85			
	JLG	Preparation of proposed Order	9.00
10/29/85			
	JLG	Telephone conference with Russell Ghent	

[Letterhead of Love, Thornton, Arnold & Thomason]

S.C. National Bank (CONTINUED)
SCN v. Darmstadter

(Judge's Clerk)	.30	
11/20/85		
JLG Receipt and review of Judge Wilkins' order; telephone conferences with Buddy Reynolds and Bill Kehl; long distance call to Henry McKellar	1.50	
FOR CURRENT SERVICES RENDERED	123.80	$8277.50
U.S. Postmaster/Fed. Express		14.00
Long Distance Telephone Calls		23.00
Depositions/Transcriptions		277.05
Photocopies		225.85
Paralegal Assistance		67.50
Legal-Ease - Research		25.00
TOTAL COSTS THRU 11/21/85		632.40
08/19/85 PAYMENT		-7475.75
TOTAL PAYMENTS		-7475.75
BALANCE DUE		$8909.90

ATTORNEY BREAKOUT (For your information):
Jennings L. Graves, Jr. (JLG):
113.40 hrs. x $70/hr. = $7938.00
John R. Devlin, Jr. (JRD):
1.10 hrs. x $55/hr. = $ 60.50
Law Clerk (LC):
9.30 hrs. x $30/hr. = $ 279.00

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

The South Carolina National Bank,	)	
Appellee,	)	
vs.	)	NO. 85-2198
Virginia L. Darmstadter,	)	
Appellant.	)	

STIPULATION FOR SUPPLEMENTAL RECORD
AND SUPPLEMENTAL APPENDIX

It is hereby stipulated and agreed by and between the attorneys for the respective parties that the matter described below shall be deemed a Supplemental Record and Supplemental Appendix in the above entitled case in the United States Court of Appeals for the Fourth Circuit:

The Proposed Order drawn by counsel for Appellee with cover letter dated January 27, 1986, a copy of which is attached hereto as Exhibit A, and which is attached to Appellant's Brief as an appendix beginning

after page 51 thereof.

s/ James R. Gilreath

3/28/, 1986

s/ H. Mark Emanuel
Attorneys for Appellant

s/ Jennings L. Graves, Jr.
Attorney for Appellee

[Letterhead of Love, Thornton,
Arnold & Thomason]

January 27, 1986

Mr. James R. Gilreath
P. O. Box 2147
Greenville, S. C. 29602

RE: SCN v. Darmstadter

Dear Jim:

Enclosed please find a copy of the Proposed Order submitted to Judge Wilkins.

I will expect to hear from you in the next couple of days on a stipulation as to damages. You can calculate the damages based on the affidavit which we have submitted to Judge Wilkins on the principal interest, attorney's fees and costs.

Yours very truly,

LOVE, THORNTON, ARNOLD
& THOMASON

s/ (Sonny)
By: Jennings L. Graves, Jr.

JLG,JR:pl

Enclosure

IN THE UNITED STATES DISTRICT COURT

FOR THE DISTRICT OF SOUTH CAROLINA

GREENVILLE DIVISION

The South Carolina National Bank,	)	
Plaintiff,	)	PROPOSED ORDER
-vs-	)	
Virginia L. Darmstadter,	)	C/A No. 6:84-2466-14
Defendant.	)	

The parties have agreed that the issues in this action are to be submitted to the Court, without a jury, for a decision. Presently before the Court are the respective Motions of the parties for summary judgment.

Jurisdiction in this matter is based upon diversity of citizenship of the parties.

The Plaintiff, The South Carolina National Bank (hereinafter "SCN"), a national bank headquartered and doing business in South Carolina, initiated the action against the Defendant, now a resident of Louisiana, for collection of unpaid amounts due on a secured promissory note.

The Defendant, by way of answer, has alleged state and federal securities violations by SCN and that as a consequence, SCN is not entitled to collect on the promissory note. The Defendant also has alleged state and federal securities violations by SCN by way of counterclaim and further has alleged by way of counterclaim breach by SCN of fiduciary obligations to the Defendant. The Court recognizes, however, that the Defendant acknowledges in her Reply Brief that she "has simply chosen to assert securities violations defensively." Therefore, the Court will only consider the allegations of securities violations as defensive in nature. The Court must address, however, the Defendant's affirmative claims in Count Five of the Counterclaim dealing with the breach of fiduciary obligations by SCN.

As in Amfac Mortgage Corporation v. Arizona Mall of Tempe, Inc., 583 F.2d 426 (9th Cir. 1978), this appears to be another attempt to convert the securities laws into a method of general relief for an unwise commercial

transaction. At a minimum, it is an attempt by a purchaser to blame a commercial lender for making a loan to the purchaser for use in what turned out to be a poor purchase.

This conclusion is reached from two avenues of approach and an analysis of the roles and involvement of the Defendant, National Railway Utilization Corporation (hereinafter "NRUC") and SCN in the transaction:

(1) The role of SCN in the transaction clearly demonstrates the characteristics of a commercial lender, and the note and collateral documents demonstrate the characteristics of a commercial loan; and,

(2) The Defendant overlooks the relevant intent of the securities laws - protection of an investor. While the Defendant may have been an investor in her purchase of managed boxcars from NRUC, SCN is the party which was induced into making a loan to the Defendant in exchange for the issuance of a note from the Defendant to SCN. As stated in Great Western Bank and Trust v. Kotz, 532 F.2d 1252, 1256

(9th Cir. 1976), "To determine whether the transaction under review involves an 'investment' in return for 'securities' within the meaning of the securities laws, we analyze the nature and degree of risk accompanying the transaction to the party providing the funds." (Emphasis added.) Here, SCN provided the funds and the Defendant issued the note, not vice versa.

The threshold question from the securities standpoint is whether SCN's loan to the Defendant and the receipt by SCN of a secured note from the Defendant constituted a security. If the secured note received by SCN in exchange for the loan, in the context of the overall transaction, and in the context of the intent of the federal and state securities laws, is a security, additional questions would arise; but if it is not a security, the Court need look no further at the Defendant's allegations of securities violations.

If the note is not a security, the only remaining issues for the Court are, as to the Complaint, SCN's damages, and, as to the

Defendant's Counterclaim, the claim by the Defendant regarding the breach of fiduciary duties by SCN.

The parties have characterized the note issued by the Defendant to the Plaintiff, and the transaction involving SCN in substantially varying terms. The Defendant has alternatively contended that SCN has liability because the note from the Defendant to SCN was a security, although the Defendant obviously was the issuer of the note, and that SCN has liability as a participant in the sale of an "investment contract" from NRUC to Defendant. On the other hand, SCN contends that it stands in the shoes of a commercial lender, that it made a commercial loan to the Defendant, that the transaction, to the extent that it involves SCN, contains all of the indicia and characteristics of a commercial loan, and that the Defendant has attempted to reverse the roles of the Defendant and SCN in a mischaracterization of who has issued a security to whom.

In order to determine if the note in question, or the note and collateral documents in the transaction, fit into the definition of a security within the intent of the securities laws, the court must first outline the structure from a factual standpoint and then analyze the structure based upon legal precedent. In so doing, this court reaches the conclusions, for the reasons hereinafter set forth, (1) that SCN was acting at all times in its customary role as a commercial lender; and, (2) that, if either party was so entitled, SCN would be the party entitled to assert that it was the victim, having been induced into departing with its money (however, it is clear to the court that SCN was a lender and not an investor, and that the Defendant was a borrower and not the issuer of a security).

FINDINGS OF FACT

The transaction involved in this matter has its origins on December 27, 1978 when the Defendant purchased two (2) railroad boxcars

through NRUC. The Defendant financed the purchase price by secured loan from SCN, and secured the loan with the asset purchased and all of the Defendant's rights arising therefrom.

During 1978, NRUC was engaged in, among other things, the business of supplying and managing general purpose railroad boxcars for its own account and for others to be used in the railroad interchange system. NRUC was and continues to be a common carrier subject to regulation by the Interstate Commerce Commission. NRUC's corporate headquarters and executive offices were and are located in Philadelphia, Pennsylvania.

In December, 1978 the Defendant was the eighth largest stockholder in NRUC, and was the director of the Washington, D. C. office of NRUC.

During 1977, the concept of the sale of railroad boxcars to individual owners and the management of those boxcars by NRUC originated with the management of NRUC. As the development of the managed boxcar concept

progressed, certain members of NRUC management realized that an investment in boxcars to be managed by NRUC might be an attractive fringe benefit for NRUC management, stockholders and other insiders. However, during the period of 1977 and 1978, the demand for boxcars far exceeded the supply and the number of boxcars available for purchase by what came to be known as the "management group" was limited.

Several members of the management group negotiated the terms of the purchase and management of the boxcars for the management group and also arranged for loans for individual members of the management group from commercial lenders. SCN was one of several lenders approached regarding loans and at least one other bank was prepared to make loans to the management group. At the time that the participating members of the management group were chosen, no lender had been selected. It is clear that the impetus for the loan transactions came from the Defendant's fellow members of the management group, and not from SCN or any other lender.

It is also clear that the terms of the loan were negotiated on behalf of the individual members of the management group by fellow members of the management group.

Likewise, the purchase of the boxcars, including the price, and the terms of the Management Agreement, including management duties and management and maintenance fees, between NRUC and the purchasers were negotiated directly between NRUC and the management group. SCN played no role in establishing the terms of the purchase and management between the individual members of the management group and NRUC.

SCN did agree to lend to the individual members of the management group ninety percent (90%) of the purchase price of boxcars to be purchased. As a secured lender, SCN participated in the structure of the loan and collateral documents. SCN required that each of its loans be collateralized and it took a security interest in the boxcars purchased, in the revenues generated by the boxcars, and in the individual borrowers' contract rights

under the Management Agreement with NRUC. The Court is aware that commercial lenders often play an active role in the determination of the terms of any loan documentation and in the terms of collateral documentation, with particular concern toward protection of the lender's position. The participation of SCN in the loan transaction herein demonstrates that it, to the extent that the superior bargaining power of any lender allows, dictated the terms of the note and security agreement, including specific terms as to the collateral.

The secured note issued by Darmstadter to SCN in exchange for the loan from SCN, provided for a fixed principal amount, interest fixed at the rate of twelve percent (12%) per annum, fixed periodic principal and interest payments, and a fixed balloon payment in July, 1984. The note and security agreement also provided for standard default terms, for acceleration in the event of default, and for attorney's fees and costs of collection in the event that legal action was

necessary. SCN further required that its collateral be properly insured and also required financial statements from the borrower prior to the closing of the loan transaction and on an annual basis thereafter. SCN, in fact, made a determination that certain of the borrowers in the management group were required to provide additional collateral, in addition to the boxcars and the proceeds of the boxcars.

NRUC and the management group determined that the revenues earned by the boxcars should be pooled in order to provide each of the members of the management group with equal treatment. The Management Agreement also provided that any member of the management group could elect to withdraw from the pooling arrangement at any time.

The Agency Agreement between each individual borrower and the SCN Trust Department provided that NRUC, once it allocated the revenues to the individual boxcars owners, would pay the net revenues to the SCN Trust Department and further provided

that the SCN Trust Department would, to the extent that funds were available in the account of each individual borrower, make the quarterly principal and interest payments to the SCN commercial loan department. The Agency Agreement also provided that any excess revenues were to be invested in a consumer passbook savings account for the benefit of each investor and required each individual borrower to be responsible for any deficiency in the quarterly principal and interest payments.

A careful review of the secured note of the Defendant demonstrates that the quarterly principal and interest payments are determined on the basis of a twelve (12) year amortization schedule and that the full remaining balance on the note was due to SCN five and one-half (5½) years after funding. Obviously, there would remain a substantial balloon payment due at maturity of the secured note, July, 1984, and SCN required as security for the full amount of the note, that the revenues generated by the boxcars, to the

extent that the revenues exceeded the quarterly principal and interest payments, be retained in an escrow account. While this may not be a commonplace feature, it is consistent with SCN's desire to be as fully protected as possible, particularly in light of the balloon payment feature of the note. The Defendant contends that this structure evidences the intent by SCN to participate in the profits to be derived solely from the efforts of others, but logic and common sense dictates that such was more likely the action of a prudent lender which was attempting to protect its loan repayment as securely as practicably possible. While the specific terms of any secured note and collateral documents might have varied from lender to lender, there is no evidence of any role played by SCN in inducing the Defendant into her purchase of boxcars, at least no role of any more significance than would have been played by any other lender, as is evidenced by the purchase of two (2) additional boxcars by the Defendant in June,

1979, with funds loaned to the Defendant by a northern bank.

Other than rights as to its collateral, SCN had no right to control NRUC or the Defendant and it had no right to share in the profits of either and did not rely on the profits of either for repayment of its loan.

CONCLUSIONS OF LAW

The definitions of "security" under the 1933 Securities Act and the Exchange Act of 1934, as well as under the South Carolina Blue Sky Laws are essentially identical and provide that the term "security" includes any note unless the context otherwise requires.

Where the South Carolina Uniform Securities Act is substantially identical to the federal provisions, South Carolina will ordinarily follow the federal court's interpretations of federal securities laws. Bradley v. Hullander, 272 S.C. 6, 249 S.E.2d 46 (1976). Since South Carolina courts have not construed the term "security" and the term "note" within the context of a security, a

discussion must necessarily deal with the federal securities laws.

> "The primary purpose of the Acts of 1933 and 1934 was to eliminate serious abuses in a largely unregulated securities market. The focus of the Acts is on the capital market of the enterprise system: the sale of securities to raise capital for profit-making purposes, the exchange on which securities are traded, and the need for regulation to prevent fraud and to protect the interests of investors. Because securities transactions are economic in character, Congress intended the application of these statutes to turn on the economic realities underlying a transaction, and not on the name appended thereto. Thus, in construing these Acts against the background of their purpose, we are guided by a traditional cannon of statutory construction:
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> > '[A] thing may be within the letter of the statute and yet not within the statute, because not within its spirit, nor within the intention of its makers.' (Citation omitted)
>
> United States Housing Foundation, Inc. v. Forman, 421 U.S. 837, 849 (1975)

With the exception of the Second Circuit, every court of appeals to recently consider the definition of the term "security" has rejected the literal approach. Other courts have uniformly refused to extend the meaning

of the definition of "security" to anything beyond that which the courts have determined that Congress intended by the enaction of the Acts of 1933 and 1934, "both of which reflected concern for the average investor against fraud in the public offering of common investment instruments." Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126, 1133 (1976). See also, United Housing Foundation, supra, 421 U.S. at 849, footnote 14.

In assessing the economic realities of the transaction, different circuits have used different tests, with the primary test being a "commercial vs. investment" test, with a lesser used test being whether or not the transaction more closely resembles a "loan" or has the risk factors associated with "risk capital". See Futura Development Corp. v. Syntex Corp., Fed. Sec. L. Rep. (CCH, ¶92,024), (1st Cir. 4/30/85). In each of these tests, while the courts have utilized different terms, a balancing test is involved in an analysis of the characteristics of the

transaction or instrument involved: that is, whether or not the transaction, based upon the economic realities, is one which the securities laws were intended to include within the definition of "security".

The Court has been presented with no authority to support the Defendant's position that the note herein is a security. In fact, the Court has not found a single case in which a borrower has successfully claimed that a note issued, in exchange for a loan, to a third party or even to a seller, much less a note to a traditional commercial lender in exchange for a loan, is a security. Further, in the one case cited by the Defendant finding a note to be a security, Exchange National Bank of Chicago v. Touche Ross & Co., 544 F.2d 1126 (2nd Cir. 1976), the suit was by the bank and the transaction did not involve a loan, but involved a purchase by the bank of subordinated notes, with the proceeds of the purchase considered by the seller of the notes (and by the New York Stock Exchange) as the equivalent of equity capital. Also, the

transaction was arranged not by the bank's commercial loan staff, but by the bank's chief administrative officer. In Exchange National, there clearly was an investment intent by the bank and by the "borrower". The "borrower" likewise sold such notes to a total of nineteen (19) different entities.

In another recent case, Hunssinger v. Rockford Business Credits, Inc., Fed. Sec. L. Rep. (CCH ¶91,684) (N.D.Ill., 10/4/84), the court also found notes to be securities. As in Exchange National, supra, the issuer of the notes in Rockford sought to raise capital for its general business enterprise and broadly solicited individual lenders to "invest". The court indicated that the transactions involved ha[illegible] none of the facts attendant in an ordinary commercial loan transaction and noted that none of the lenders was in the business of making commercial loans. As one would expect, suit in Hunssinger was initiated by those individuals who were induced into making loans to the issuer of the notes, the reverse of the fact situation here.

In Oliver v. Bostetter, 426 F.Supp. 1082 (D.Md., 1977), upon which the Defendant heavily relies, and which interestingly held that a note given in payment of the purchase of corporate stock was not a security, our fellow district court cited to a detailed law review article: Comment Notes As Securities Under The Securities Act of 1933 and the Securities Exchange Act of 1934, 36 Md.L.R.233 (1976). Therein, the author in footnote 15 wrote:

> Although experts in the securities field are not in total agreement, it appears that as used technically in the industry, the term "note" is not simply the common law promissory note. The characteristics that distinguish the notes security from other types of notes are that these notes are generally issued by corporations, governments and other public bodies (Citations omitted), are bought and sold on the open market by the public (Citations omitted), and are usually bought for the purpose of realizing pecuniary gain, generally in the form of income, interest or capital gains (Citations omitted).

The article also discusses why a note given to a bank in exchange for a loan is not

a security. See footnote 68 and the accompanying text.

As stated above, the various tests utilized by the courts deal with whether or not the note has the characteristic of an investment or of a commercial transaction. These factors, while each may be analyzed individually, should be considered in their combined effect. Amfac Mortgage Corp., supra, at 432. In other words, was SCN making an investment or was SCN making a commercial loan? There is a total absence of any facts which indicate that SCN was making an investment. If this case were placed within the context of most cases in which the questions herein are raised, SCN would be the plaintiff, contending that the Defendant induced SCN into the purchase of a security, the note from the Defendant. The court cannot conceive of any characteristic of this transaction which would allow SCN to pursue securities violations against Darmstadter.

SCN is in the business of making loans. While the court assumes that SCN, as many

banks, also makes investments, this transaction involved only the commercial loan department of SCN and not the investment department.

The note herein was issued within the context of a commercial loan transaction and not within the context of a "purchase" of securities by SCN. See Exchange National Bank of Chicago, supra, 1134-35. The loan was represented by a promissory note and by collateral documents, providing to SCN collateral in all of the Defendant's rights in the collateral, including the right to income earned by the collateral. The note was for a fixed sum and provided for interest at a fixed rate and for payments in fixed amounts and at fixed rates. It contained standard default provisions and SCN had the right to accelerate upon default and to pursue the borrower and the collateral. Given the balloon payment feature of the note, SCN's requirement that it retain any excess revenues during the term of the note, was reasonable within the context of the requirements of a commercial lender.

SCN did not look to the profitability of NRUC or the success of the Defendant for repayment. It analyzed the credit position of the Defendant prior to the loan transaction and determined that she had sufficient assets for repayment of the loan, aside from her purchase of the boxcars. The Defendant was also specifically required to be responsible for any deficiency in the quarterly payments.

A "commercial note", particularly one not subject to further trading, as distinguished from an "investment note" is not a security. C.N.S. Enterprises, Inc. v. G & G Enterprises, Inc., 508 F.2d 1354, 1356 (7th Cir. 1975). The court in C.N.S. Enterprises, Inc. indicated that there was no evidence that the notes represented anything beyond the borrowing of money to make partial payment upon the purchase of the assets of a business and that there was nothing to indicate that the bank was an investor or a co-partner in the business. Clearly, SCN, by lending its funds, did not seek to invest and the Defendant, by borrowing and issuing its note,

did not seek to induce an investment by SCN. Similiarly, while any commercial lender expects profit from a loan, it does not intend to make investments by making commercial loans. See Oliver, supra, at 1085-87. The court in Oliver relied upon the suggestion in the 1976 Maryland law review article discussed above in making an analysis based upon the "economic reality" approach first articulated in S.E.C. v. W. J. Howey Co., 328 U.S. 293, 298 (1946). See also National Bank of Commerce of Dallas v. All American Assurance Company, 583 F.2d 1295, 1301 (5th Cir. 1978), which adds the factor that there is no "class of investors" involved, only one lender.

The Sixth Circuit recently overruled a district court decision holding that notes evidencing loans from a commercial lender were securities. Davis v. Avco Financial Services, Inc., 739 F.2d 1057 (6th Cir. 1984). Therein, the court stated:

> Although promissory notes can sometimes be considered securities, we think it obvious that the notes executed by the plaintiff to Avco were not. They were notes executed

> to a finance company in the ordinary course of its business. The fact that Avco knew that the loan proceeds would be used for an investment in D.T.B.G. does not in our opinion make the notes securities. (Citations omitted).

The First Circuit in Futura, supra, at 91,070, indicated that Congress did not intend all business transactions involving notes to be viewed as the purchase and sale of a security and that among the relevant factors, all of which dictate that the note here was commercial in nature, were:

> ...the degree to which the profit on a note is in the hands of the maker rather than the payee; whether the object of the holder was to acquire an interest in the property or enterprise; whether the note was primarily commercial because it was serving as a "cash substitute" for the purchase price; and whether the return on the note was predetermined or could reasonably be anticipated, or was subject to the managerial efforts of the maker.

The Defendant has attempted to taint SCN with the characteristics of the transaction between the Defendant and NRUC. However, while the Court acknowledges that SCN necessarily became involved in the transaction between the Defendant and NRUC to the extent

necessary to fully document and protect its loan and collateral, there is no evidence that SCN thereby intended to be making an investment or that it took any steps to induce any investment by the Defendant. The Defendant has overlooked the role played by her peers in the management group of NRUC and has attempted to blame SCN for her reliance upon her associates in the NRUC management group. If this court ruled that a lender was required to treat its commercial loans as securities, and to inquire in detail as to the securities aspects of the purchases by borrowers, the logical result would be an unnecessary and unintended hampering of the commercial loan process and of lending as we now know it. The court therefore concludes that the note issued by the Defendant to SCN was not a security, under any of the tests used by the courts. The factors involved demonstrate a pure commercial loan transaction.

The second issue as to whether or not SCN has any liability as a participant in the sale

of an "investment contract" from NRUC to Defendant must be answered in the negative. The Defendant has again cited no authority in support of its position. In a state court case, Getz. v. Central National Bank of Greencastle, 261 N.E.2d 81,85 (Ind., 1970) the court ruled that the involvement of the bank, which was in many ways similar to SCN's position herein, "did not constitute direct or indirect participation in the distribution" of an investment contract. This court is persuaded by the conclusions drawn by the court in Getz, which, while it dealt with this issue as opposed to the issue of whether or not the note issued by the borrower to Central National bank was a security, uses a similar approach in determining that the lender was not a participant in the distribution of an investment contract.

In light of the Defendant's failure to cite any authority that a commercial lender, by agreeing to perform its normal banking functions, would be classified as a participant in the sale of a security, the

court concludes that the Plaintiff's role in the overall transaction was as that of a lender and not an investor or a participant in the distribution of an investment contract.

Having so decided, that leaves for the court the issue of damages sought by the Plaintiff in its Complaint and the claim of breach of fiduciary duties in Count Five of the Defendant's Counterclaim. The court will address the issues of damages claimed by the Plaintiff at a later time. However, the court will address the contentions of the Defendant in Count Five of its Counterclaim, the matter being raised by the motion for summary judgment of the Plaintiff.

The Defendant's Counterclaim contends that SCN "agreed and purported to hold Defendant's equity and interest in the investment for the benefit of Defendant" and as such, that SCN "had statutory and common law fiduciary duties to protect and promote the Defendant's equity and interest in the investment on behalf of Defendant."

The Defendant has not asserted what statutory and common law fiduciary duties exist on the part of SCN and specifically has avoided any consideration of the only agreement giving rise to any agency or fiduciary obligations of SCN, the Agency Agreement.

The secured note and the security agreement provide for nothing other than the loan and collateral for the loan. "There is no confidential relationship between a bank and its customers merely because the customer has advised with, relied upon, and trusted the bankers in the past." Citizens & Southern National Bank v. Arnold, 240 Ga. 200, 240 S.E.2d 3 (1977).

> The mere fact that one reposes trust and confidence in another does not create a confidential relationship. In the majority of business dealings, opposite parties have trust and confidence in each other's integrity, but there is created no confidential relationship by this alone (Citations omitted). Appellant has shown no special relationship imposed upon the bank either by statute or by contract to protect his rights to the exclusion of those of any others. On the contrary, the evidence shows that

> the bank held documents of indebtedness and dealt with (plaintiff) at arm's length as a creditor to a debtor.
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> Limoli v. First Georgia Bank, 147 Ga.App. 755, 250 S.E.2d 155 (1978).

Defendant borrowed Sixty-Nine Thousand, Nine Hundred Six and no/100ths ($69,906.00) Dollars from SCN and issued to SCN her secured note for that amount. As collateral for the note, Defendant entered into a security agreement with SCN which provided as security the two boxcars purchased by Defendant, and the proceeds therefrom. The title passed to the Defendant at the time of the purchase and SCN took only collateral rights as a secured lender.

The only duties of SCN, other than the duties of a secured lender, were set out in the Agency Agreement which provided (1) that SCN was to perform only the duties set forth in the Agency Agreement; (2) that SCN was to receive the Defendant's boxcar revenues and invest the same in a consumer passbook savings account so long as it held the funds; and (3) that SCN was to notify and report to the

Defendant on receipts and disbursements, including payments on the Defendant's loan with SCN.

There is a total absence of any fiduciary obligation of SCN to the Defendant other than those specified on the Agency Agreement. The Complaint does not allege breach of any obligations arising from the Agency Agreement.

> [I]t is clear that the fiduciary duty arises only when the evidence establishes that the party providing the financing to a corporation completely dominates and controls its affairs...To justify the imposition of a fiduciary obligation on a party financing the affairs of a corporation, it must be shown that the financing party essentially dominated the will of its debtor.
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> Edwards v. Northwestern Bank, 39 N.C.App. 261, 250 S.E.2d 651, 662 (1979).

Based upon the authorities cited, the Court finds that the evidence is clear that SCN had no fiduciary duties to Defendant other than as set out in the Agency Agreement, and as to those, no breaches existed.

SUMMARY

As stated herein, the Court has concluded:

(1) that the note issued by the Defendant to SCN was not a security;

(2) that SCN's role in the overall transaction was as that of a lender and not as that of an investor or participant in the distribution of any security; and,

(3) that SCN has breached no fiduciary duties to the Defendant.

AND IT IS SO ORDERED.

W. W. WILKINS, JR.
U. S. District Judge

Greenville, South Carolina

September _____, 1985